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Supreme Court of the United States

OCTOBER TERM, 1935

No. 743

FRANK O. LOWDEN, JAMES E. GORMAN AND JOSEPH B. FLEMING, as Trustees of the Estate of the Chicago, Rock Island & Pacific Railway Company,

vs.

NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, MINNESOTA, Formerly the Northwestern National Bank of Minneapolis, Minnesota.

On Certificate from the United States Circuit Court of Appeals for the Eighth Circuit

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BRIEF OF AMICUS CURIA

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Service of this Brief is hereby accepted and copies acknowledged received, this..... day of April, 1936, by the undersigned.

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BRIEF OF AMICUS CURIA

BRIEF FILED WITH LEAVE OF COURT

This Brief is filed with leave of Court first had, by Garfield E. Breese as amicus curia.

OPINION BELOW

The opinion of the District Court below was filed June 17, 1935. It is reported as **Lowden, et al vs. Northwestern National Bank and Trust Company of Minneapolis,** in 11 Fed. Suppl. 929 (D. C., Minn.). The Circuit Court of Appeals has filed no opinion, reserving decision pending the opinion of this Court upon the questions certified.

JURISDICTION

The United States Circuit Court of Appeals, Eighth Circuit, has certified to this Court, three questions of law involved in this cause, under the provisions of Section 239 of the Judicial Code as amended (28 U. S. C. A. Sec. 346).

QUESTIONS CERTIFIED

The questions certified for answer, in the order certified, are as follows:

> Question 1. Does the right of setoff recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that act?
>
> Question 2. If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?
>
> Question 3. If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of setoff, recognize and establish as a proper setoff by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the Court in which that petition was filed and approved?

STATUTES INVOLVED

The statutes directly involved are Sec. 77 of the Banktruptcy

Act (as adopted March 3, 1933), U. S. C. A. Sec. 205; and Sec. 68 of the Bankruptcy Act, U. S. C. A. Sec. 108.

Said Section 77 is set forth in full as an Appendix to Appellants' Brief (p. 65).

The material parts of said Section 68 are as follows:

"(a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

"(b) A setoff or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate * * *"

Said Section 77 provides:

"(n) In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the Court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and his property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed."

"(g) Upon such approval by the commission, and after hearing such objections as may be made to the approved plan, the Judge shall confirm the plan if satisfied that (1) the approved plan complies with the provisions of subdivision (b) of this section, is equitable and does not discriminate unfairly in favor of any class of creditors or stockholders; * * * (6) the plan provides with respect to any class of creditors the acceptance of which is requisite to the confirmation of the plan, and who would not become bound by the plan under the provisions of subdivision (h) of this section, adequate protection for the realization by them of the value of their securities, liens, and claims, either (a) by the sale of such property subject to their liens, if any, or (b) by the sale free of such liens at

not less than a fair upset price, and the transfer of such liens to the proceeds of such sale, or (c) by appraisal and payment in cash of either the value of such liens and claims or, at the objecting creditors' election, the value of the securities allotted to such liens and claims under the plan. * * *"

STATEMENT OF CASE

The statement of the case as certified by the United States Circuit Court of Appeals is set out on pages 2-4 of Appellants' Brief.

SUMMARY OF ARGUMENT

I

Question No. 1. Does the right of setoff recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that act?

A. Setoff is a substantive right, not merely a procedural remedy, based upon a possessory lien.

B. The reorganization statute, Sec. 77(n), by its terms provides that consistent therewith, the rights and liabilities of creditors shall be the same as in the case of voluntary bankruptcy, which is "one debt shall be setoff against the other, and the balance only shall be allowed or paid." (Sec. 68(a).

C. If right of setoff is denied, the possessory lien is destroyed, since the fund would be checked out and the creditor would take only with general creditors.

D. Enjoining foreclosure of collateral pending efforts to reorganize the debtor, does not destroy the collateral or preferred position of the creditor. But denial of right of setoff, destroys it and the possessory lien on which it is based.

II

Question No. 2. If the first question be answered in the affirmative, can a bank which owns unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

A. Maturity of the bonds is not essential to exercise of right of setoff, because unmatured debts are provable and therefore may be set off under Sec. 68.

B. Neither is insolvency of the railway essential to the setoff:

1. Because insolvency is not a prerequisite to adjudication of bankruptcy under Sec. 68.
2. Because Sec. 68 gives right of setoff without reference to insolvency of debtor.

C. Even if insolvency of the railway were to be held essential to exercise of right of setoff, the fact of insolvency must be regarded as proven:

1. Because inability to meet its debts as they mature and availing itself of the benefits of Sec. 77 are sufficient proof thereof.
2. Because to hold that insolvency of the railway company can be proven only through the marshalling of assets against liabilities, would be to hold that all ordinary creditors, those not having millions at stake, would be helpless because a court of equity had required proof beyond the reach and power of any such creditor.

D. The bank owning railway bonds owing by the railway company and being indebted to the railway company, on checking account, there exists mutual debts and credits, contemplated by Sec. 68 (a).

III

Question No. 3. If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by that bank under the claimed right of setoff, recognize and establish as a proper setoff by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved?

A. At the time the railway company petition was filed and approved, under Sec. 77, the bank was a debtor of the railway company on the railway's checking account, and a creditor of the railway by virtue of holding railway bonds. No possession, actual or constructive, of property was involved—merely a creditor and debtor relationship—therefore "one debt shall be set off against the other and the balance only shall be allowed or paid." (Sec. 68(a).

B. The good faith assertion of lien on property of the bankrupt, where the property and claimant are outside the jurisdiction of the Bankruptcy Court, requires the trustee in bankruptcy, who would contest that lien, to seek relief in the court of the jurisdiction of the property or claimant.

C. Were Sec. 77 to be given the necessarily strained construction, to authorize such plenary jurisdiction in the Bankruptcy Court, still the latter can consent to such jurisdiction in other competent courts. The bringing of this action by the trustees in the United States District Court of Minnesota, presumes such consent.

Were the above proposition not true, then we would have the anomalous situation where the trustees in

bankruptcy could invoke the jurisdiction of the United States District Court in Minnesota and be accorded relief therein and at the same time successfully resist the right of the adverse party to be heard in opposition to the trustees' claim.

ARGUMENT

I

Question No. 1 is as follows: Does the right of setoff recognized by Section 68(a) of the Bankruptcy Act apply to reorganization proceedings under Section 77 of that act?

A. The right of setoff is a substantive right, not merely a procedural remedy.

In **First National Bank vs. Malone,** 76 Fed. (2d) 251 (8 C. C. A.), the Court, discussing the equitable origin and nature of setoff and its accomplishment of justice, said:

> "While the doctrine was originally 'a mere procedural convenience, it has now become really a requirement of substantive justice.'"

In **Wisdom vs. Guess Dry Cleaning Co.,** 5 Fed. Suppl. 762 (Dist. Mass.), after an extensive discussion of the setoff right, the Court said:

> "We have seen that the better modern view regards setoff as a substantive right."

The right has been characterized as in the nature of a lien, by this court and others. **Central National Bank vs. Connecticut, etc., Co.,** 104 U. S. 54; **Goodwin vs. Barre Savings, etc., Co.,** 91 Vt. 286; **Andrew vs. American Savings Bank,** 218 Iowa 489; see also **Champlin Refining Co vs. Gasoline Products Co.,** 29

Fed. (2d) 331, 338 (1 C. C. A.); **In re W. & A. Bacon Co.**, 261 Fed. 109, 111 (Dist. Mass.).

In **Studley vs. Roylston National Bank,** 229 U. S. 523, this court, in sustaining the right in bankruptcy proceedings, said:

> "That section did not create the right of setoff, but recognized its existence, and provided a method by which it could be enforced even after bankruptcy. What the old books called a right of stoppage—what business men call setoff—is a right given or recognized by the commercial law of each of the states, and is protected by the bankruptcy act if the petition is filed before the parties have themselves given checks, charged notes, made book entries, or stated an account whereby the smaller obligation is applied on the larger.
>
> "**The banker's lien on deposits,** the right of retention and setoff of mutual debts, are frequently spoken of as though they were synonymous, while in strictness, a setoff is a counterclaim which the defendant may interpose by way of cross-action against the plaintiff. But, broadly speakin, **it represents the right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other.** That right is constantly exercised by business men in making book entries whereby one mutual debt is applied against another." (Boldface ours).

The setoff right is one which the courts zealously guard.

In **Central Appalachian Co. vs. Buchanan,** 90 Fed. 454 (6 C. C. A., before Taft and Lurton, Circuit Judges, and Clark, District Judge), in an extensive discussion of the setoff right, the Court said:

> "So, courts of equity of the United States have been peculiarly alert to prevent the defeat of an equitable right of setoff by the interposition of assignments, receiverships or

statutory liquidations, and to extend the right whenever there appeared any substantial equity in favor of the claim."

B. Subdivision "n" of Section 77 (the reorganization statute) by its terms provides that consistent therewith, the rights and liabilities of creditors shall be the same as in the case of voluntary bankruptcy, which is "one debt shall be set off against the other, and the balance only shall be allowed or paid." (Sec. 68(a).

To answer Question 1 in the negative would be to say that the above provision of the statute is meaningless—an idle gesture. To hold that the right of setoff does not apply under Section 77 would be to read inconsistent language into the statute or to give it a strained construction wholly at variance with its plain terms.

C. Denial of the right of setoff utterly destroys the right. The distinction between enjoining the temporary foreclosure of a collateral lien such as was done in the case of Continental Illinois National Bank and Trust Company vs. C. R. I. & P. Ry. Co. (decision by U. S. Supreme Court April 1, 1935, 79 L. Ed. 642) on the one hand, and the denial of right of setoff on the other, should be clearly noted, because enjoining the foreclosure of collateral does not destroy, but merely suspends the right, while denial of the right of setoff utterly destroys the right because the subject of the setoff (the checking account in the bank) will be checked out and nothing will be left to set off.

As applied to the case at hand, denial of the right of setoff would deprive the bank, for all time, of the setoff right by destroying it, and would directly contravene the provisions of said Section 77, subdivisions (d) to (g).

Sub-paragraph 6 of subdivision (g) requires the preservation of the setoff right in different language:

> "adequate protection for the realization by them (creditors) of the value of their securities, liens and claims."

The Continental Illinois National Bank & Trust Company case, supra, makes positive that statement (referring to the enjoining of foreclosure of collateral) in the following language:

> "The injunction does not infringe Sec. 67(d) U. S. C. A., Title 11, Sec. 107(d). The substance of that provision is that bona fide liens shall not be affected by anything contained in the Bankruptcy Act. The injunction here in no way impairs the lien, or disturbs the preferred rank of the pledgees. **It does no more than suspend the enforcement of the lien."** (Boldface ours).

To argue then, that the right of setoff is not available under Sec. 77, is not only to misinterpret plain provisions of subdivision "n", but also to ignore the holding of the Supreme Court of the United States in the Continental Illinois Bank case.

II

Question No. 2 is as follows: If the first question be answered in the affirmative, can a bank which owns the unmatured bonds of a railroad corporation set off a deposit account of the railroad with the bank against the bonds, upon the filing by the railroad of a petition for reorganization under Section 77 of the Bankruptcy Act, alleging that the railroad is unable to meet its debts as they mature?

A. The maturity of the bonds in question is not essential to the exercise of right of setoff, because unmatured debts are provable in bankruptcy and therefore subject to setoff under Section 68 of the Bankruptcy Act.

Section 63(a)(1) of the Bankruptcy Act provides:

> "Debts provable against: (a) Debts of the bankrupt may be proved and allowed against his estate which are

(1) a fixed liability as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not."

Not only is maturity not essential, but the debits and credits may have arisen out of wholly disconnected transactions.

In the case of **North Chicago Rolling Mill Co. vs. St. Louis Ore & Steel Co.**, 152 U. S. 596; 38 L. Ed. 565, the Court said:

"Cross demands and counterclaims, whether arising out of the same or wholly disconnected transactions, and whether liquidated or unliquidated, may be enforced by way of setoff whenever the circumstances are such as to warrant the interference of equity to prevent wrong and injustice."

B. Insolvency of the Railway Company is not essential to exercise the right of setoff.

Insolvency is not a prerequisite to adjudication of bankruptcy under Section 68.

George M. West Co. vs. Lea Brothers & Co., 174 U. S. 590; **In re Cohn**, 227 Fed. 843 (certiorari denied); **Blumenthal vs. Strat**, 241 U. S. 662; **In re C. R. I. & P. Ry. Co., 72 Fed.** (2d) 443; 450; **In re Hargadine, etc., Co.**, 239 Fed. 155 (Dist. Mo.); **In re Dressler Producing Corp.**, 262 Fed. 257 (2 C. C. A.); **1 Remington on Bankruptcy** (4th Ed.), Sec. 48; 11 U. S. C. A., Sec. 21, note 2-p. 177, note 82-p. 213, note 132-p. 235, and numerous cases cited.

Therefore under the Bankruptcy Act we have the situation where insolvency of the bankrupt is not essential, and yet where, under Section 68, the right of setoff is allowed.

C. Even were it to be conceded (which of course it is not) that insolvency of the Railway were essential to exercise of the right of setoff by the bank, the fact of insolvency must be regarded as proven:

1. Because the admission that the Railway was unable to meet its debts as they mature, and as a consequence availed itself of the provisions of Section 77, establishes the fact of insolvency for all practical purposes.
2. Because to hold otherwise would be to hold that insolvency of the Railway could be proven only through the marshaling of assets against liabilities.

The requirement of such proof would place an utterly insolvent Railway in an enviable and unjustifiable position as against practically all creditors, because such proof would be impossible at the hands of such creditors. To establish such a rule as the basis for proof of insolvency, the court of equity would be merely saying to all creditors except multi-millionaires, that even though the Railway is insolvent, it will require proofs thereof that are to all practical purposes impossible.

We submit that a court of equity will not place creditors in that position.

D. The requirement of mutuality of debits and credits, under Section 68, is met where the Railway Company is indebted to the Bank on its bonds and the Bank is indebted to the Railway on checking account carried by the Railway Company in the Bank.

Again we quote from the case of **North Chicago Rolling Mill Company vs. St. Louis Ore & Steel Co.**, 152 U. S. 596; 38 L. Ed. 565:

"Cross demands and counterclaims, whether arising out of the same or wholly disconnected transactions, and whether liquidated or unliquidated, may be enforced by

way of setoff whenever the circumstances are such as to warrant the interference of equity to prevent wrong and injustice."

In the case of **Scott vs. Armstrong,** 146 U. S. 499; 36 L. Ed. 1059, the Court says:

"Courts of equity frequently deviate from the strict rule of mutuality when the justice of the particular case requires it."

In the case of **Bank of Commerce & Trust Company vs. Hood,** 65 Fed. (2d) 281 (5th C. C. A.) the Court dealt with a situation where the bank owned bonds which it proposed to offset against the bank balance in the general deposit account of the depositor.

The Court said:

"But it should not have required the turning into the hands of its receiver of $19,466.56 of money without reference to the offsets claimed by the bank against the mortgagor. The general deposit was but a debt, and the receiver standing in the shoes of Willets Wood Products Company, was entitled only to an account and the payment of the balance, if any."

In the late case of **First National Bank of Indianola vs. Malone, et al,** 76 Fed. (2d) 251 (C. C. A. 8th), the Court says:

"Where no superior equities intervene, the setoff of a deposit against the debt upon an unmatured note is allowed upon the theory that in good conscience one ought not pay his debt to his creditor if he cannot ultimately compel his creditor to pay the debt due him. * * * The fact that the claim of the bank on its note was not due at the moment of suspension of the bank, cannot have the effect of

destroying the mutuality essential to the right of setoff."

In the case of **McDaniel National Bank vs. Bridwell,** 74 Fed. (2d) 331 (C. C. A. 8th), the Court referred to subdivision (a) of Section 68 of the Bankruptcy Act, and stated:

> "From the wording of this sub-section it is evident that, before the creditor may enjoy the use of a setoff principle against the bankrupt's estate, two essential elements must be established: (1) Two debts must exist, one to the creditor and one to the bankrupt's estate; (2) These debts must be mutual, that is, the creditor's debt must be owing to the estate of the bankrupt and the estate's debt must be owed to this creditor. When these conditions are fulfilled, the statute applies with full force and may be taken advantage of."

III

Question No. 3 is as follows: If the first and second questions be answered in the affirmative, may the United States District Court for the District of Minnesota, in the suit by the trustees of the railroad's estate to recover the amount deducted from the account of the railroad by the bank under the claimed right of setoff, recognize and establish as a proper setoff by the bank one which was not made until after the filing of the petition for reorganization and which has never been ordered, authorized, approved, or consented to by the court in which that petition was filed and approved."

A. At the time the Railway Company's petition was filed and approved by the Bankruptcy Court, the bank was a debtor of the Railway Company by virtue of the Railway Company's checking account in the Bank, and the Bank on the other hand was a creditor of the Rail-

way Company by virtue of its ownership of railway bonds. No possession, actual or constructive, of the property was involved—merely a creditor and debtor relationship; therefore, "one debt shall be setoff against the other, and the balance only shall be allowed or paid." (Sec. 66a).

The argument that the jurisdiction of the Bankruptcy Court where the petition was filed, was so exclusive that setoff of mutual credits against mutual debts would not be permissible (and that is what a negative answer to Question No. 3 would mean) would be to carry logic beyond the realm of reason, and reason beyond the realm of logic.

In the first place the jurisdiction of that court is necessarily administrative.

Batbbitt vs. Dutcher, 216 U. S. 102, 109;

U. S. Fidelity & Guaranty Co., vs. Bray, 225 U. S. 205, 217;

The basis of such jurisdiction is actual or constructive possession of the debtor's property. **Isaacs vs. Hobbs,** 282 U. S. 734, 737; **Ex parte Baldwin,** 291 U. S. 610, 615; **Gross vs. Irving Trust Co.,** 289 U. S. 342, 344; **Board of Trade vs. Johnson,** 264 U. S. 1, 11; **Remington on Bankruptcy** (3rd Ed.), Sec. 2350, p. 410.

Without such possession the bankruptcy court lacks jurisdiction even as to property within its territorial limits. **Harrison vs. Chamberlin,** 271 U. S. 191, 193; **Galbraith vs. Vallely,** 256 U. S. 46, 50; **Jaquith vs. Rowley,** 188 U. S. 620, 625; **In re Uittenbogard,** 295 Fed. 778 (8 C. C. A.)

B. The good faith assertion of a lien on property of the debtor, where the property and claimant are ouside the jurisdiction of the Bankruptcy Court, requires the trustee in bankruptcy, who would contest that lien, to seek relief by plenary action in the court of the jurisdiction

of the property or claimant.

The language of Section 23 of the Bankruptcy Act makes this plain. That section provides as follows:

"(a) The United States District Courts shall have jurisdiction of all controversies at law and in equity, as distinguished from proceedings in bankruptcy, between trustees as such and adverse claimants concerning the property acquired or claimed by the trustees, in the same manner and to the same extent only as though bankruptcy proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants.

"(b) Suits by the trustee shall only be brought or prosecuted in the courts where the bankrupt whose estate is being administered by such trustee, might have brought or prosecuted them if proceedings in bankruptcy had not been instituted, unless by consent of the proposed defendant except suits for the recovery of property under Section 96, subdivision "b" of this title; Section 107, subdivision "e" of this title; and Section 110, subdivision "e" of this title."

The point is also determined by the United States Supreme Court in the case of **Bardes vs. Bank,** 178 U. S. 524:

"On the contrary, Congress, by the second clause of Sec. 23 of the present Bankrupt Act, appears to this court to have clearly manifested its intention that controversies, not strictly or properly part of the proceedings in bankruptcy, but independent suits brought by the trustee in bankruptcy to assert a title to money or property as assets of the bankruptcy against strangers to those proceedings, should not come within the jurisdiction of the District Courts of the United States, 'unless by consent of the proposed defendant,' of which there is no pretense in this case."

In First National Bank vs. Chicago Title & Trust Company 198 U. S. 280, this court said:

> "The distinction between steps in bankruptcy proceedings proper and controversies arising out of the settlement of the estates of bankrupts is recognized in Sections 23, 24, and 25 of the present act. * * * This distinction existed under the prior bankruptcy law, and the then decisions in respect of a proceeding in bankruptcy and an independent suit are applicable. It was settled that the bankruptcy court was without jurisdiction to determine adverse claims to property, not in the possession of the assignee in bankruptcy, by summary proceedings, whether absolute title or only a lien was asserted. * * *
>
> "The present act was plainly framed in recognition of the principle of these cases."

This Brief, to avoid repetition, adopts the further argument on this proposition set forth in the Brief of Appellee, pages 56 to 65, both inclusive, it being our opinion that the same fairly fully and irrefutably covers the proposition.

C. Were Section 77 to be given the necessarily strained construction to hold that such plenary jurisdiction, rests in the Bankruptcy Court, still that Court can consent to such jurisdiction in other competent courts. The bringing of this action by the trustees in the United States District Court of Minnesota, presumes such consent. To hold otherwise would be to hold that the trustees acted illegally. This presumption will not be indulged.

D. It would give rise to an anomalous situation were the trustees permitted to invoke the jurisdiction of the United States District Court of Minnesota, and then be heard to deny that jurisdiction.

It should be borne in mind that the action is brought by the trustees for affirmative relief. To answer Question 3 in the negative would be in effect to permit the trustees to invoke the jurisdiction of the Minnesota court and obtain relief therefrom, and at the same time to grant the trustees the right to deny the adverse parties the right to be heard in that court.

The right does not exist in the trustees to receive in that Court and not to give. Jurisdiction in that Court in the first instance precludes denial of its jurisdiction as to the counter features involved.

Were the holding to be that the Minnesota Court is without jurisdiction, then it necessarily follows that the plaintiff's action arising therein and invoking that Court's jurisdiction, should be dismissed. We believe that that jurisdiction was properly invoked by the plaintiffs at the inception of this action, but were it to be held otherwise, we respectfully ask that in the determination of the questions certified, the Court specify fully the status of the parties in relation to said action, including the provision that the plaintiff's action itself must fail in order that the rights of the parties to the action may all be preserved for assertion in the proper forum.

CONCLUSION

We respectfully submit that the three certified questions should each and all be answered in the affirmative.

We respectfully ask that any contrary holding be accompanied by suitable direction and qualifications such that the rights of the defendant by way of setoff shall not be destroyed.

March 27, 1936.

Respectfully submitted,

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